between interstate access services and other services such as video distribution.[379] No evidence has been presented, however, indicating any likelihood that current price cap regulation, which is designed, in part, to prevent cross subsidization, might become less effective under a market-based approach to access charge reform. Those price cap regulations will remain in place until there is sufficient competition to prevent an incumbent LEC from charging rates that are not just and reasonable. Therefore, we find that the record does not contain substantial evidence that a market-based approach to access charge reform is any less likely than current regulation to permit incumbent LECs to engage in unreasonable cross subsidization with their interstate access charges.

284. Finally, several commenters based their support for a market-based approach, in part, on arguments that it would reduce, or minimize, administrative burdens. Other commenters, on the other hand, opposed a market-based approach on the grounds that it would increase administrative burdens. Based on the record before us, however, we cannot reach a conclusion as to the relative administrative burdens of the two approaches. Some parts of our proposed market-based approach, such as grants of increased pricing flexibility as competitive conditions warranted, were modeled on waivers that we have granted within the context of our current price cap plan and would likely be necessary even if we had adopted a primarily prescriptive approach to access charge rate level reform. Similarly, some parts of a prescriptive approach, such as annual changes in price cap calculations, will necessarily be a part of our market-based approach. Accordingly, we can see no basis in this record for concluding that a market-based approach to access charge reform will be any more or less burdensome than any other alternative.

B. Prescriptive Approaches

1. Prescription of a New X-Factor

a. Background

285. In the NPRM, we observed that the Commission had initiated a rulemaking proceeding in the *Price Cap Fourth Further NPRM* to examine a number of proposals for revising the productivity offset component of the X-Factor, and to consider related issues such as eliminating sharing obligations and the low-end adjustment mechanism.[380] We invited

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[379] *See* Appendix B, Section IV.A, *infra.*

[380] NPRM at ¶ 233. With respect to the productivity offset, we invited comment on, among other things, basing it on total factor productivity (TFP). TFP is the ratio of an index of a firm's total outputs to an index of its total inputs. NPRM at ¶ 233 n.300, *citing Price Cap Fourth Further NPRM,* 10 FCC Rcd at 12663-71. With respect to sharing, we noted that, although sharing tends to blunt the efficiency incentives otherwise created by the price cap plan, it also serves beneficial functions, and we invited comment on eliminating sharing and establishing other mechanisms to serve those functions. NPRM at ¶ 233 n.301, *citing Price Cap Fourth Further*

parties to discuss in this proceeding whether the record developed pursuant to the *Price Cap Fourth Further NPRM* justified increasing the productivity offset, and specifically invited comment on the effects of a forward-looking cost of capital and economic depreciation on total factor productivity (TFP) measurement.[381]

b. Discussion

286. The commenters generally repeat arguments made in the *Price Cap Fourth Further NPRM* proceeding. For reasons explained in detail in our companion *Price Cap Fourth Report and Order*, we conclude that we should prescribe an X-Factor on the basis of total factor productivity studies, the difference between LEC input price changes and input price changes in the economy as a whole, and the 0.5 percent consumer productivity dividend (CPD). In the companion order we find that this results in an X-Factor prescription of 6.5 percent.

2. Other Prescriptive Approaches

a. Background

287. In the NPRM, we sought comment on four options for a prescriptive approach: reinitializing price cap indices (PCIs) to economic cost-based levels;[382] reinitializing PCIs to levels targeted to yield no more than an 11.25 percent rate of return, or some other rate of return;[383] adding a policy-based mechanism similar to the CPD to the X-Factor;[384] or prescribing economic cost-based rates.[385] We have decided above to rely primarily on a market-based approach, and impose prescriptive requirements only when market forces are inadequate to ensure just and reasonable rates for particular services or areas. We will determine the details of our market-based approach in a future Order. In that Order, we will also discuss in more detail what prescriptive requirements we will use as a backstop to our

NPRM, 10 FCC Rcd at 12676-80.

[381] NPRM at ¶ 233. GTE notes that, while the X-Factor received considerable attention in the *Price Cap Fourth Further NPRM* proceeding, the discussion did not focus on the effects of the 1996 Act. GTE Comments at 57.

[382] NPRM at ¶¶ 223-27.

[383] NPRM at ¶¶ 228-30.

[384] NPRM at ¶¶ 231-32.

[385] NPRM at ¶¶ 236-38.

market-based access charge reform.[386] In this Section, we explain why we have decided not to adopt any specific prescriptive mechanism in this Order.

b. Rate Prescription

288. *Background.* We sought comment on prescribing new interstate access rates because simply reinitializing PCIs would not necessarily compel incumbent LECs to establish reasonable rate structures.[387] We also noted, however, that prescribing access rates on a TSLRIC basis could raise common cost allocation issues to a much greater extent than did TELRIC pricing for unbundled network elements.[388]

289. *Discussion.* In Section IV.A, above, we explain why we can and should rely primarily on market forces to cause interstate access rates to move toward economic cost levels over the next several years. Prescribing TSLRIC-based access rates would be the most direct, uniform way of moving those rates to cost. But, precisely because of its directness and uniformity, rate regulation can only be, at best, an imperfect substitute for market forces. Regulation cannot replicate the complex and dynamic ways in which competition will affect the prices, service offerings, and investment decisions of both incumbent LECs and their competitors. A market-based approach to rate regulation should produce, for consumers of telecommunications services, a better combination of prices, choices, and innovation than can be achieved through rate prescription. A market-based approach, with continued price cap regulation of services not subject to substantial competition and with the prescriptive backstop described in Section IV.A, is thus consistent both with the pro-competitive, deregulatory goals of the 1996 Act and with our responsibility under Title II, Part I of the Communications Act to ensure just and reasonable rates.

290. Furthermore, immediate prescription of TSLRIC-based rates would not necessarily move rates to those levels faster than the market-based approach and prescriptive backstop developed in Section IV.A. Some parties that favor a prescriptive approach have asserted that setting access rates immediately at TSLRIC levels would reduce incumbent LEC revenues by $10 billion or more.[389] Were we to make such a rate prescription, we would consider phasing in rate reductions of that magnitude over a period of years, in order to avoid

[386] In Section IV.A of this Order, we state that we will require incumbent price cap LECs to file forward-looking economic cost studies on or before February 8, 2001.

[387] NPRM at ¶ 236.

[388] NPRM at ¶ 237.

[389] *See* NPRM at ¶ 7 and sources cited therein.

the rate shock that would accompany such a great rate reduction at one time.[390] Finally, because we have adopted a more efficient rate structure for interstate switched access services, it is not necessary to prescribe new rates in order to achieve efficient rate structures, as TRA and TCI recommend. Accordingly, we will not prescribe TSLRIC-based access rates at this time.

c. Reinitialization of PCIs on a Rate-of-Return Basis

291. *Discussion.* We reject reinitialization on the basis of any rate of return at this time. As a general matter, the parties advocating a rate-of-return based reinitialization do not provide any persuasive reason for adopting that particular approach. They favor reinitialization largely because they believe interstate access charges should be lower than they are now. As explained above, however, we are adopting a primarily market-based approach to rate level adjustments. The prescriptive backstop to that approach will be based on TSLRIC cost studies and, most likely, applied to geographically deaveraged rates. That approach is more likely to result in rates that are aligned with economic costs than would reinitialization to a particular rate of return on an embedded cost rate base.

292. Moreover, because the basic theory of our existing price cap regime is that the prospect of retaining higher earnings gives carriers an incentive to become more efficient, we believe that rate of return-based reinitialization would have substantial pernicious effects on the efficiency objectives of our current policies.[391] In this regard, we have often expressed concern in past price cap orders that maintaining links between rate levels and a carrier's achieved rate of return would undercut the efficiency incentives price cap regulation was designed to encourage. In the *LEC Price Cap Order*, we rejected a so-called "automatic stabilizer" adjustment to the price cap index that -- like reinitialization -- would have permanently adjusted index levels downward in the event that carriers achieved earnings above a certain rate of return.[392] Similarly, in our 1995 *LEC Price Cap Performance Review*

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[390] *See Investigation of Special Access Tariffs of Local Exchange Carriers*, CC Docket No. 85-166, Phase I and Phase II, Part 1, FCC 84-524, 57 Rad.Reg. 2d 188, 209 (released Nov. 9, 1984).

[391] Ad Hoc's suggestion that we require a PCI reinitialization based on the currently-authorized 11.25 percent rate of return -- while administratively simpler than some other ways of changing rate levels -- would undermine productivity incentives by imposing the greatest penalties (rate reductions) on those carriers that had improved their efficiency the most. Reinitialization to another rate of return level, as API suggests, could, in addition, require resolution of complex and time-consuming issues. *See, e.g.*, Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 89-624, 5 FCC Rcd 7507 (1990) (taking about a year to resolve all relevant issues raised in prescribing the currently-authorized 11.25 percent rate of return).

[392] *LEC Price Cap Order*, 5 FCC Rcd at 6803. We adopted instead a sharing mechanism that made one-time earnings-related adjustments to PCI levels to ensure that carriers would "share" significant productivity gains in a given year with ratepayers, but would not be penalized by permanent downward adjustments to the track that

Order, we cited as a disadvantage of AT&T's "Direct Model" method of determining the PCI formula's "X-Factor" the fact that "a target rate of return is a critical factor in measuring productivity."[393] And although we sought comment in the *Access Reform NPRM* on the question of rate of return-based reinitialization of the price cap indices, we once again expressed concern that such action "could have a negative effect on the productivity incentives of the LEC price cap plan."[394] We, of course, have authority to change our methods and theories of regulating LEC rates when we believe the purposes of the Communications Act would be better served by doing so. However, we find that, given our consistently critical past statements about rate of return-based adjustments to price caps, a decision now to reinitialize PCIs to any specified rate of return would further undermine future efficiency incentives by making carriers less confident in the constancy of our regulatory policies.

293. In declining to reinitialize PCIs on the basis of carriers' rates of return, we reject GSA/DOD's suggestion that access rates have been excessive merely because the earnings of most price cap carriers have exceeded 11.25 percent, and, in some cases, by substantial amounts. When the Commission adopted price cap regulation, it specifically permitted price cap carriers to earn in excess of 11.25 percent in order to encourage them to become more productive.[395] The Commission also concluded that complaints alleging excessive earnings relative to costs will not lie as long as the carrier is in compliance with the sharing mechanism.[396] In addition, we found in the *LEC Price Cap Performance Review Order* that access rates declined substantially under price cap regulation from 1991 to 1994, in spite of the increases in earnings to which GSA/DOD alluded.[397] Furthermore, the vastly different results among companies[398] show that the incentive plan we have for cost reduction (price caps) largely is working as predicted, whereas a rate-of-return-based scheme would have cost much in terms of inefficiency.

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the PCI otherwise would have taken. We have found that even the sharing mechanism tends to blunt efficiency incentives, and, in part for that reason, we are removing the sharing mechanism as well in Section IV of our companion *Price Cap Fourth Report and Order.*

[393] *LEC Price Cap Performance Review Order*, 10 FCC Rcd at 9034.

[394] NPRM at ¶ 230.

[395] *LEC Price Cap Order*, 5 FCC Rcd at 6787.

[396] *LEC Price Cap Order*, 5 FCC Rcd at 6836.

[397] We found that the cumulative effect of price cap regulation from 1991 to 1994 was approximately $5.9 billion. *LEC Price Cap Performance Review Order*, 10 FCC Rcd at 8986-87. We do not know for certain, but believe that the benefits to access customers would have been smaller under rate-of-return regulation.

[398] *See, e.g.*, 1996 Annual Access Filings, 11 FCC Rcd 7564 (Com.Car.Bur. 1996).

d. Reinitialization of PCIs on a TSLRIC Basis

i. Background

294. In the NPRM, we sought comment on reducing price cap PCIs by an amount equal to the difference between the incumbent LECs' PCIs and the revenues that would be produced by rates set at TSLRIC levels. We noted that a TSLRIC-based PCI reinitialization might be preferable to a TSLRIC-based rate prescription because it would not require us to prescribe common cost allocations.[399] We also sought comment on whether or to what extent we could rely on TELRIC studies developed for pricing unbundled network elements, and whether we should initiate joint board proceedings to rely on state commissions to evaluate the incumbent LECs' TELRIC studies.[400]

ii. Discussion

295. We have decided not to require incumbent LECs to reinitialize PCIs on a TSLRIC basis at this time. As we discuss in Section IV.A above, we expect market forces to develop as a result of the 1996 Act and to drive access rate levels to forward-looking economic costs. Furthermore, the record in this proceeding is unclear on whether there is an accurate and convenient method for determining TSLRIC for purposes of reinitializing PCIs at this time. Specifically, it is unclear whether the TELRIC studies used to develop unbundled network element prices can be used for access services.[401]

e. Policy-Based X-Factor Increase

i. Background

296. In the NPRM, we observed that we adopted a consumer productivity dividend (CPD) to assure that some portion of the benefits of the incumbent LECs' increased productivity growth under price cap regulation would flow to ratepayers in the form of reduced rates. We sought comment on establishing a policy-based mechanism similar to the CPD to force access rates to cost-based levels.[402]

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[399] NPRM at ¶ 223.

[400] NPRM at ¶¶ 224-25.

[401] *Universal Service Order* at ¶ 245.

[402] NPRM at ¶¶ 231-32.

ii. Discussion

297. *Discussion.* We do not require a policy-based X-Factor increase at this time for the same reason we do not require a TSLRIC-based PCI reinitialization; we expect market forces to control access charges effectively in a less intrusive manner.

298. BellSouth and GTE oppose increasing the CPD as an arbitrary and confiscatory measure.[403] SNET claims that increasing the X-Factor merely because the price cap LECs have earned too much, or simply to drive rates down, is essentially an abandonment of price cap regulation, because it would punish incumbent LECs for their efficiency gains made under the price cap regime.[404] BA/NYNEX and GTE contend that the X-Factor should be chosen to reflect reasonably expected incumbent LEC productivity growth rather than to achieve a specific rate reduction.[405] We emphasize that we have done nothing in this Order to increase the X-Factor. In our companion *Price Cap Fourth Report and Order*, we prescribe a new X-Factor of 6.5 percent, but this prescription is based on detailed studies of LEC productivity growth and input price changes.[406] We decline to increase the CPD,[407] and we reject a proposal to set the X-Factor to target an industry average rate of return of 11.25 percent.[408] Thus, none of our actions in either this Order or our companion Order can properly be characterized as an abandonment of price cap regulation, or as motivated merely by a desire to drive rates down.

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[403] BellSouth Comments at 49; GTE Comments at 77-78.

[404] SNET Reply at 23-24. *See also* BA/NYNEX Reply at 32-33.

[405] BA/NYNEX Reply at 30; GTE Reply at 26-27.

[406] *Price Cap Fourth Report and Order*, Section III.E.

[407] *Price Cap Fourth Report and Order*, Section III.D.5.

[408] *Price Cap Fourth Report and Order*, Section III.B.

C. Equal Access Costs

1. Background

299. In the NPRM, we solicited comment on whether to require incumbent price cap LECs to make an exogenous cost decrease to one or more of their PCIs to account for the completion of the amortization of equal access costs on December 31, 1993.[409]

300. Under court order, the BOCs and GTE were required to provide equal access.[410] This conversion, estimated at more than $2.6 billion, was largely completed by 1990, and involved both capital and non-capital expenditures. Under the *Equal Access Cost Order*, incumbent LECs were required to identify separately the incremental capital investments and the incremental non-capital-related expenses associated with the implementation of equal access. The *Equal Access Cost Order* directed that the capital investments, which it estimated to comprise approximately 55 percent of the $2.6 billion, be treated pursuant to ordinary accounting and ratemaking principles.[411] The Commission determined that the remaining 45 percent of the expenditures -- which were non-capitalized equal access expenses -- required special treatment:

> [W]e are concerned that these expenditures will cause irregular and substantial fluctuations in revenue requirements associated with equal access. Because they are extraordinary, are for the greatest part expected to be incurred over the next few years, and, therefore, are likely to be distortive of financial results and

[409] NPRM at ¶ 293. We note that through the years, this issue has been referred to as "equal access network reconfiguration" or EANR costs. This is a misnomer, which we correct today. "Equal access" is the provision of exchange access to all interexchange carriers on an unbundled, tariffed basis that is equal in type, quality, and price to that provided to AT&T and its affiliates. *Equal Access and Network Reconfiguration Costs, Memorandum Opinion and Order*, 50 Fed. Reg. 50910 (rel. Dec. 9, 1985) at ¶ 18 (*Equal Access Cost Order*). "Network Reconfiguration" costs are those investments and expenses incurred in connection with structurally conforming the pre-divestiture AT&T network with the LATA boundaries mandated by the MFJ. *Id.* Issues underlying network reconfiguration costs were resolved in the *Equal Access Cost Order* and have not been raised since. *See Id.* at ¶ 22.

[410] *See United States v. AT&T*, 552 F. Supp. 131, 233 (D.D.C. 1982); *United States v. GTE Corp.*, 603 F. Supp. 730, 745 (D.D.C. 1984).

[411] *Equal Access Cost Order*, 50 Fed. Reg. at 50914, ¶ 32 ("[W]e believe that the capital cost of equal access service is best measured in the traditional manner whereby the cost of investments are recovered over their useful lives. This is best accomplished by using FCC prescribed depreciation lives for the classes of property associated with equal access.").

> rate requirements, we find that these equal access expenses should be deferred and amortized.[412]

The Commission ordered that these equal access expenses be separately identified and recorded, and that they be written off over a period of eight years, ending December 31, 1993.[413] In the reconsideration of the *Equal Access Cost Order*, the Commission found that the specific termination date of the eight year amortization of these expenses would "shorten the period during which the unamortized balances are entitled to earn a rate of return."[414] It is clear that the LECs' rate-of-return (ROR) rates included revenue recovery for both capitalized expenditures (recovered through the ordinary depreciation process) <u>and</u> non-capitalized expenses (recovered through the special amortization process).[415] It is also clear that at the time the amortization was imposed, the Commission envisioned an end to the recovery for the amortized expenses and a subsequent decrease in ROR rates.[416]

301. In converting to price cap regulation, the Commission found that equal access conversion was, in large part, completed and that the associated costs, which included both the capitalized expenditures and the amortized expenses, were embedded in the existing rates. As such, the Commission refused to grant LECs an exogenous increase for equal access costs, finding that these costs were already accounted for in the existing rates.[417] The Commission also based its decision to deny an exogenous increase on its concern that exogenous treatment of equal access expenditures would create inappropriate incentives for the LECs to inflate the amounts spent on equal access. The Commission noted the difficulty of reviewing equal access costs, as well as the risk that incumbent LECs might willfully or inadvertently shift switched access costs into the proposed equal access category in order to benefit from the requested exogenous increase.[418]

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[412] *Equal Access Cost Order*, 50 Fed. Reg. at 50914-15, ¶ 33.

[413] *Equal Access Cost Reconsideration Order*, at 437 ¶ 25.

[414] *Equal Access Cost Reconsideration Order*, at 437 ¶ 25.

[415] *LEC Price Cap Order*, 5 FCC Rcd at 6808, ¶ 180.

[416] *Equal Access Cost Reconsideration Order*, at 437 ¶ 25.

[417] *LEC Price Cap Order*, 5 FCC Rcd at 6808, ¶ 180.

[418] *LEC Price Cap Order*, 5 FCC Rcd at 6808, ¶ 180.

2. Discussion

302. We find that an exogenous cost decrease to account for completion of the amortization of equal access non-capitalized expenses is necessary and appropriate. Although we have addressed this issue in the past and declined to act, we now find that an exogenous decrease is merited. We recognize our decision departs from our past decisions that have declined to impose an exogenous decrease for the completed recovery of these costs. As discussed below, our decision today reverses those decisions and is based on an extensive record from this, and prior proceedings.[419] Our decision today aligns our treatment of the completion of the amortization of equal access costs with two other similar amortizations that were ordered under ROR regulation and carried over into price cap regulation, namely, the exogenous decrease imposed for the completion of the amortization of depreciation reserve deficiencies,[420] and the exogenous decrease imposed for the completion of the amortization of inside wire costs.[421] We are convinced that this treatment is the proper method to ensure that ratepayers are not paying for costs that have already been completely recovered.

303. The need for an exogenous adjustment to account for the expiration of the equal access expense amortization stems from the different ways in which rates are established under ROR regulation, on the one hand, and price cap regulation, on the other hand, and from the Commission's decision to establish initial price cap levels at the outset of price cap regulation on the basis of existing ROR-derived rates.[422] When converting from ROR

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[419] In addition to the comments received in this proceeding, our record is supplemented by commentary from interested parties in a number of prior proceedings, including comments filed in connection with the following orders: *LEC Price Cap Order*, 5 FCC Rcd 6786 (1990); *LEC Price Cap Reconsideration Order*, 6 FCC Rcd 2637 (1991); *Commission Requirements for Cost Support Material To Be Filed with 1994 Annual Access Tariffs*, 9 FCC Rcd 1060; *1994 First Annual Access Tariff Order*, 9 FCC Rcd 3705; *Second 1994 Annual Access Order*, 9 FCC Rcd 3519; *1993-1996 Annual Access Tariff Filings*, CC Docket Nos. 93-193 and 94-65, Memorandum Opinion and Order, FCC 97-139 (rel. April 17, 1997).

[420] *LEC Price Cap Order*, 5 FCC Rcd at 6808, ¶ 173.

[421] *LEC Price Cap Reconsideration Order*, 6 FCC Rcd at 2673-2674, ¶¶ 78-82 (imposing exogenous cost decrease for the completion of amortization of inside wire costs).

[422] Under ROR regulation, rates for a particular service are determined annually by a calculation from the ground up of the company-specific costs associated with the provision of that service. Expenses generally are recovered in their entirety through rates in the year in which they are incurred. Asset costs generally are capitalized and recovered over the assets' useful lives through rates that are designed to reflect the annual depreciation expenses associated with the assets and a return on the undepreciated (remaining) portion of the assets. Under price caps, rates are not developed each year through a "ground up" calculation of company-specific costs. Instead, rates are set according to a formula that measures the incremental change in costs each year -- as reflected (a) in the movement of surrogates (*i.e.*, GDP-PI minus X) for so-called "endogenous" costs over which the carrier can exercise some control, and (b) in the company-specific measurement of certain "exogenous" cost changes that are not reflected in the "GDP-PI minus X" variable and are beyond the carriers'

regulation to price cap on regulation January 1, 1991, the Commission needed to select a set of "baseline" rate levels to which the price cap index of incremental cost changes would be tied. For that purpose, we chose the ROR-developed rates that were in effect on July 1, 1990.[423] The Commission found that, in general, those rates served as an appropriate starting point for measuring subsequent incremental cost changes under price cap regulation, because they "reflect[ed] the reasonable operation of ROR regulation."[424]

304. In two respects, however, the Commission recognized that existing rates did not reflect equilibrium ROR-derived rates, but rather reflected special corrective adjustments that we had ordered previously. In particular, the Commission noted that existing rates had embedded within them costs associated with Commission-ordered "one-time" amortizations of depreciation reserve deficiencies and inside wiring costs.[425] Had ROR regulation continued, the rates subject to these amortizations would have been reduced when the amortizations were completed. To ensure that ratepayers under price caps would not be required permanently to bear these temporary Commission-ordered, ROR-derived rate adjustments, we directed LECs to make downward exogenous cost adjustments to their price cap indices upon the expiration of those amortizations.[426]

305. Similarly, the Commission ordered amortization of equal access expenses, which also were reflected in baseline rates at the outset of price cap regulation. Under normal ROR ratemaking principles, those expenses -- which, for the most part, already had been incurred before price cap regulation was initiated -- would have been recovered in the BOCs' rates the same year they were incurred and would no longer have been reflected in rates at the time price caps were instituted. However, as explained *supra*, the Commission required the carriers to amortize these extraordinary expenses over eight years because of the potential fluctuations

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control.

[423] *LEC Price Cap Order*, 5 FCC Rcd at 6814, ¶ 230.

[424] *Id.* at ¶ 232.

[425] *See Price Cap Further Notice of Proposed Rulemaking*, 3 FCC Rcd at 3419-23 ¶¶ 413-420. The depreciation reserve deficiency amortization was a "one-time correction device" ordered by the Commission to address the fact that the depreciation rates prescribed by the Commission had significantly overstated the useful lives of LEC assets. The Commission temporarily raised LEC rates to recover that deficiency. *Price Cap Further Notice*, 3 FCC Rcd at 3421-22, ¶¶ 417-18. The inside wiring amortizations provided a mechanism for LECs to recover from regulated ratepayers investments in activities that were regulated at the time the investments were made, but which the Commission had deregulated on a going-forward basis. *Id.*, 3 FCC Rcd at 3422-23, ¶¶ 419-420.

[426] *LEC Price Cap Order*, 5 FCC Rcd at 6808, ¶ 173; *LEC Price Cap Reconsideration*, 6 FCC Rcd at 2673-74, ¶¶ 78-80.

in revenue requirements associated with equal access.[427] Thus these expenses remained embedded within BOC rates at the outset of price caps even though, for the most part, the extraordinary expenses themselves were no longer being incurred.

306. The specific question of whether the completely amortized equal access expenses should be treated exogenously has been presented to the Commission on a number of occasions.[428] In the past, procedural impediments arising from our rules, as well as the lack of an adequate record, convinced us to decline to impose such treatment at that time. For example, when AT&T raised the issue of downward adjustment for completed amortization of equal access expenses in an annual access charge tariff proceeding, the Common Carrier Bureau found that the issue was beyond the scope of the proceeding because it would require a substantive change to the price cap rules.[429] Similarly, in response to AT&T's and MCI's revisiting the question in both the *First 1994 Annual Access Charge Order* and the *Second 1994 Annual Access Charge Order*, the Commission found that exogenous treatment would require a rule change to section 61.45(d) of the Commission's rules. Because no LEC had filed for a waiver of section 61.45(d), the Common Carrier Bureau found that the issue was not properly presented for investigation.[430]

307. In denying the requests for procedural reasons, the Commission supported its decisions with various rationales. In some instances, these rationales appear now not to have been considered to a sufficient degree. In addressing equal access costs in the orders adopting price cap regulation, the Commission focused primarily on the question of whether future equal access investments and expenses should be treated exogenously because equal access had been compelled by regulatory (or judicial) order.[431] We concluded, subject to consideration of waiver requests, that we should not accord exogenous cost treatment to such future equal access conversion costs, because of concerns that exogenous cost treatment would

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[427] *Equal Access Cost Order*, 50 Fed. Reg. at 50914-15, ¶ 33 (1985).

[428] *See, e.g., LEC Price Cap Reconsideration*, 6 FCC Rcd at 2667, ¶ 66 n.77; *Commission Requirements for Cost Support Material To Be Filed with 1994 Annual Access Tariffs*, 9 FCC Rcd 1060, 1063, ¶¶ 21-22 (rel. Feb. 18, 1994) (*1994 Annual Access TRP*); *First 1994 Annual Access Charge Order*, 9 FCC Rcd 3705, 3730-37311 at ¶¶ 54-56 (rel. June 24, 1994); *Second 1994 Annual Access Charge Order*, 9 FCC Rcd 3519, 3535-3536 at ¶¶ 36-38 (rel. June 24, 1994).

[429] *1994 Annual Access TRP*, 9 FCC Rcd at 1063, ¶¶ 21-22.

[430] *See First 1994 Annual Access Charge Order*, 9 FCC Rcd at 3731; *Second 1994 Annual Access Charge Order*, 9 FCC Rcd at 3536. *See also 1993-1996 Annual Access Tariff Filings*, CC Docket Nos. 93-193 and 94-65, Memorandum Opinion and Order, FCC 97-139 (rel. April 17, 1997), at ¶ 82.

[431] *LEC Price Cap Order*, 5 FCC Rcd at 6808 ¶¶ 180-181. The amortization requirement had applied only to court-ordered conversion to equal access by the BOCs. The Commission, however, had also had required independent LECs to convert to equal access upon bona fide request.

create disincentives to implement equal access in an efficient manner.[432] We did not focus in detail on the logically distinct question of whether equal access expenses that were already embedded within baseline BOC rates pursuant to the temporary "one-time" amortizations (and thus raised no question with respect to future incentives) should be removed through exogenous adjustments when the amortizations expired.[433] Instead, we relegated that issue to a footnote, which denied exogenous cost treatment on the basis of a skeletal analysis that makes no reference to our treatment of the depreciation reserve deficiency and inside wiring amortizations. In the footnote, it is clear that the Commission was not distinguishing between capitalized costs, which were properly treated as depreciated expenses, and non-capitalized expenses, which were actually amortized per the Commission's own requirement.[434] The Commission framed the issue of a downward adjustment in terms of whether the completion of depreciation required a downward adjustment, querying "whether the BOCs will experience any cost change in 1994 [at the completion of the amortization] that stems from factors beyond their control." In support of its implicitly negative answer, the Commission analogized to the absence of a price cap index change when a piece of equipment is fully depreciated, or when a carrier increased or decreased the speed with which it recovered investments.[435] The Commission found that, "[b]ased on a meager factual record presented on the issue of equal access expense, we are reluctant to depart from our practice of not adjusting PCI levels to reflect levels of cost recovery."[436]

308. The Commission's analysis at that time was incomplete. The *Equal Access Cost Order* and the *Equal Access Cost Reconsideration Order* explicitly recognized two components of equal access costs -- capitalized, which were to be depreciated, and non-

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[432] *See LEC Price Cap Reconsideration*, 6 FCC Rcd at 2666-67, ¶ 66.

[433] *See LEC Price Cap Reconsideration*, 6 FCC Rcd at 2667 n.77. In several subsequent orders addressing BOC tariff filings implementing our price cap rules, we rejected contentions that we order downward exogenous cost adjustments to the carriers' price cap indexes to account for the expiration of the equal access cost amortizations. *See, e.g., 1994 Annual Access TRP*, 9 FCC Rcd at 1063, ¶¶ 21-22. We did so primarily on procedural grounds -- *i.e.*, that the treatment of such amortizations had already been decided in the price cap rulemaking proceeding and that a tariff proceeding was not the proper vehicle for changing that treatment. *Id. See also First 1994 Annual Access Charge Order*, 9 FCC Rcd at 3731; *Second 1994 Annual Access Charge Order*, 9 FCC Rcd at 3536; *1993-1996 Annual Access Tariff Filings*, CC Docket Nos. 93-193 and 94-65, Memorandum Opinion and Order, FCC 97-139 (rel. April 17, 1997), at ¶ 82.

[434] *LEC Price Cap Reconsideration*, 6 FCC Rcd at 2667, ¶ 66 n.77 ("We also decline to adopt MCI's suggestion to treat BOC equal access costs *in the same way we do amortizations*") (emphasis added).

[435] *LEC Price Cap Reconsideration*, 6 FCC Rcd at 2667, ¶ 66 n.77.

[436] *LEC Price Cap Reconsideration*, 6 FCC Rcd at 2667, ¶ 66 n.77.

capitalized, which were extraordinary and were to be amortized over a set period.[437] The Commission established different treatment for these two sets of costs based on policy reasons, and ordered an amortization schedule for the non-capitalized costs. The Commission's establishment of this schedule was beyond the incumbent LECs' control. The Commission's analogy to the lack of exogenous treatment for equipment depreciation and changes in the tempo of recovery should have only applied to the capitalized portion of the equal access costs.

309. The Commission explicitly stated in the *LEC Price Cap Order* that completed amortizations of depreciation reserve deficiencies require an exogenous downward adjustment.[438] The Commission found that such an adjustment was necessary to ensure that ratepayers were not paying for a cost that no longer existed. Analytically, the amortized portion of equal access expenses should have been treated in the same fashion as the amortized depreciation reserve deficiency costs. The Commission's imposition of a downward exogenous adjustment for the completion of inside wire amortizations further supports our finding today that an exogenous decrease is appropriate and necessary for the completion of the amortization of equal access non-capitalized expenses.[439]

310. We reject our prior analysis of amortized equal access costs and accord the expiration of equal access cost amortizations the same exogenous cost treatment given to the amortizations of the depreciation reserve deficiencies and inside wiring costs. Both of those amortizations were given exogenous cost treatment when they expired because they reflected temporary, one-time treatment of costs under ROR regulation that, due to the mid-stream switch to price cap regulation, would have become permanent (even though the costs already had been recovered) absent an exogenous cost adjustment. The same is true for equal access cost amortizations.

311. Because this is a rulemaking, we do not face the same procedural impediments as in some of our prior decisions, as explained *supra*. We determine that the record from this proceeding allows us to make a reasoned decision on this issue. We find that an exogenous decrease is necessary in order to adjust the price caps for the completed recovery of the specified equal access non-capitalized expenses that we required be amortized over an eight-year period. Because the current price cap index includes an expense that has now been completely recovered, the price cap should be adjusted downward to account its recovery. Simply stated, we find that ratepayers should not be forced to pay for a cost that, were it not

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[437] *Equal Access Cost Order*, at ¶ 33.

[438] *LEC Price Cap Order*, 5 FCC Rcd at 6808, ¶ 173 (discussing exogenous treatment of expiration of amortizations to correct depreciation reserve deficiencies).

[439] *LEC Price Cap Reconsideration*, 6 FCC Rcd at 2673-74, ¶¶ 78-82.

for the way price cap regulation occurred in this instance, they would no longer be paying. By imposing a downward exogenous adjustment to adjust the PCI for the complete recovery of specific equal access expenses through amortization, we will avoid unfairly imposing a subsidy burden on ratepayers. Our decision in this matter will align charges more closely to costs.

312. Several commenters have argued that they continue to incur costs as a part of the provision of equal access. These ongoing costs are not at issue in the present proceeding. As explained above, the costs at issue were a set of costs that the Commission determined should be amortized for policy reasons. These costs were extraordinary and, if allowed to be imposed in the normal fashion, would have resulted in huge rate fluctuations. We consider the ongoing costs of providing equal access as part of the normal costs of providing telephone service. Exogenous treatment of these costs is unnecessary. In response to BellSouth's contention that the record is inadequate for us to make a decision about an exogenous decrease, we find that the current record provides a sufficient basis for our decision.[440] Furthermore, we note that in the past, the record may have been sufficient, but, as explained above, the Commission's analysis was incorrect.

313. TCA and GCI are concerned about how the Commission will treat cost recovery for LECs that convert to equal access in the future.[441] As we stated in the *LEC Price Cap First Report and Order*, LECs that have not received a *bona fide* request for equal access at the time they become subject to price cap regulation may request a waiver for special treatment of those special conversion costs when the time arises.[442]

314. We hereby direct price cap LECs to make a downward exogenous adjustment to the traffic sensitive basket in the Annual Access Tariff filing that takes effect on July 1, 1997 to account for the completed amortization of equal access expenses.

D. Correction of Improper Cost Allocations

1. Marketing Expenses

a. Background

315. Prior to 1987, incumbent LEC marketing expenses were allocated between the interstate and intrastate jurisdictions on the basis of local and toll revenues. In 1987, a

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[440] BellSouth Comments at 87.

[441] TCA Comments at 5-6; GCI Comments at 8.

[442] *See LEC Price Cap First Report and Order*, 4 FCC Rcd 2873, 3190 at ¶ 657.

Federal-State Joint Board recommended that interstate access revenues be excluded from the allocation factor used to apportion marketing expenses between the interstate and intrastate jurisdictions because marketing expenses are not incurred in the provision of interstate access services.[443] The Commission agreed with the Joint Board's recommendation and adopted new procedures that allocated marketing expenses in Account 6610 on the basis of revenues excluding access revenues.[444] In petitions for reconsideration of the Commission's order, several incumbent LECs argued that the revised separations treatment of marketing expenses would result in a significant, nationwide shift of $475 million in revenue requirements to the intrastate jurisdiction.[445] On reconsideration, the Commission adopted for marketing expenses an interim allocation factor that includes access revenues, pending the outcome of a further inquiry by the Joint Board.[446]

316. In the NPRM, we stated that some of the difference between the price cap LECs' interstate allocated costs and forward-looking costs may be traced to past regulatory practices that were designed to shift some costs from the intrastate jurisdiction to the interstate jurisdiction in order to further universal service goals.[447] We observed that the Commission's decision in the *Marketing Expense Reconsideration Order* to allocate intrastate marketing costs to the interstate jurisdiction was an example of such past regulatory practices.[448] We asked parties to comment on the extent to which the difference between price cap LECs' interstate allocated costs and forward-looking costs is a result of such decisions.[449]

[443] Amendment of Part 67 (New Part 36) of the Commission's Rules and Establishment of a Federal-State Joint Board, CC Docket No. 86-297, Recommended Decision and Order, 2 FCC Rcd 2582 (1987) (*Marketing Expense Recommended Decision*).

[444] MTS and WATS Market Structure, Amendment of Part 67 (New Part 36) of the Commission's Rules and Establishment of a Federal-State Joint Board, CC Docket Nos. 78-72, 80-286, and 86-297, Report and Order, 2 FCC Rcd 2639 (1987).

[445] MTS and WATS Market Structure, Amendment of Part 67 (New Part 36) of the Commission's Rules and Establishment of a Joint Board, CC Docket No. 78-72, 80-286, and 86-297, Memorandum Opinion and Order on Reconsideration and Supplemental Notice of Proposed Rulemaking, 2 FCC Rcd 5349, 5350 (1987) (*Marketing Expense Reconsideration Order*).

[446] *Marketing Expense Reconsideration Order*, 2 FCC Rcd at 5353. *See also* 47 C.F.R. § 36.372.

[447] NPRM at ¶ 249.

[448] NPRM at ¶ 249.

[449] NPRM at ¶ 254.

b. Discussion

317. Under current separations procedures, approximately 25 percent of price cap LECs' total marketing expenses are allocated to the interstate jurisdiction.[450] We agree with parties that contend that, because marketing expenses generally are incurred in connection with promoting the sale of retail services, those expenses for the most part should be recovered from incumbent LEC retail services, which are found predominantly in the intrastate jurisdiction. Pursuant to section 410(c) of the Act, however, the Commission must refer any rulemaking proceeding regarding the jurisdictional separation of common carrier property and expenses between interstate and intrastate operations to a Federal-State Joint Board.[451] We intend to initiate a proceeding to review comprehensively our Part 36 jurisdictional separations procedures in the near future. We will refer this issue to the Federal-State Joint Board in CC Docket No. 80-286 for resolution as part of that comprehensive review. We therefore do not reallocate these costs between the interstate and intrastate jurisdictions at this time.

318. In the *Marketing Expense Recommended Decision*, the Joint Board stated that the inclusion of access revenues in the allocation factor for marketing expenses is unreasonable because incumbent LECs do not actively market or advertise access services.[452] Although parties contested the accuracy of this statement on reconsideration, the Commission did not assess incumbent LEC claims that the decision to exclude access revenues in the allocator for marketing expenses was based on an inaccurate perception of the extent to which LECs actively market or advertise exchange access services. The Commission instead referred marketing expense issues back to the Joint Board, with specific instruction to the parties to identify any Account 6610 marketing activities that are related to access services and any such activities that are related to a specific jurisdiction. We continue to recognize that some expenses recorded in Account 6610 may indeed be incurred in the provision of interstate access service, and that this is an issue that must be addressed by the Joint Board when it examines the appropriate allocation factor for marketing expenses. We note, however, that the Commission did not find in the *Marketing Expense Reconsideration Order* that the Joint Board's initial conclusion in the *Marketing Expense Recommended Decision* that incumbent LECs do not market or advertise access services to be inaccurate.

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[450] 1996 ARMIS Access Report.

[451] 47 U.S.C. § 410(c). As noted above, when the Commission reconsidered its decision to exclude interstate access revenues from the allocation factor used to apportion marketing expenses between the interstate and intrastate jurisdictions and adopted an interim allocation factor based on both local revenues and interstate access revenues, it referred the issue back to the Federal-State Joint Board in CC Docket No. 80-286 to recommend a permanent solution. *Marketing Expense Reconsideration Order*, 2 FCC Rcd at 5353.

[452] *Marketing Expense Recommended Decision*, 2 FCC Rcd at 2589.

319. We conclude that price cap LECs' marketing costs that are not related to the sale or advertising of interstate switched access services are not appropriately recovered from IXCs through per-minute interstate switched access charges. Pending a recommendation by the Joint Board on a new method of apportioning marketing costs between the intrastate and interstate jurisdictions, we direct price cap LECs to recover marketing expenses allocated to the interstate jurisdiction from end users on a per-line basis, for the reasons we discuss below.

320. Recovering these expenses from end users instead of from IXCs is consistent with principles of cost-causation to the extent that price cap LEC sales and advertising activities are aimed at selling retail services to end users, and not at selling switched access services to IXCs. Recovery on a per-line basis, while perhaps not precisely reflective of the manner in which marketing costs are incurred, is preferable to the current rule requiring price cap LECs to recover their marketing expenses through per-minute access charges. A price cap LEC's retail marketing costs are not caused by usage of switched access services, and its efforts to sell additional lines, vertical features, and other retail services would only indirectly cause an increase in switched access usage. Per-minute recovery of retail marketing costs thus distorts prices in the long distance and local markets in the same way as does per-minute recovery of other NTS costs.

321. In the past, price cap LEC retail marketing may have focused on the sale of optional vertical features such as call waiting and caller ID, and on features and services designed for business customers. As local competition develops, we would expect that sales expenses would be driven by the price cap LEC's need to respond to competition. In any case, it is beyond our jurisdiction to reassign retail marketing costs to retail services on a truly cost-causative basis. There is probably a relationship, however, between the number of lines purchased by an end user, particularly a business user, and the amount of effort a price cap LEC expends to sell services and features to that end user. Furthermore, as parties have observed in the record in this proceeding, price cap LECs actively market second lines to residential customers.[453] We conclude, therefore, that the most efficient and cost-causative method legally available to this Commission at this time for recovery of price cap LEC retail marketing costs allocated to the interstate jurisdiction is to charge those end users to whom the price cap LECs' marketing is directed -- multi-line business and non-primary residential line end users. We further note that by not permitting price cap LECs to recover these costs from primary residential and single-line business customers, we avoid potential universal service concerns that weigh against increasing charges on these end users.[454]

[453] CompuServe/Prodigy Comments at 14; America On-Line Reply at 12. *See also* Letter from Bruce K. Cox, Vice President, Government Affairs, AT&T, to William F. Caton, Acting Secretary, Federal Communications Commission, March 19, 1997.

[454] *See* Section III.A.2, *supra*; *see also* Section V.B of the *Universal Service Order*.

322. Moreover, continued recovery of interstate-allocated marketing expenses in per-minute switched access charges would raise competitive concerns. Increasingly, IXCs will be competing with incumbent, price cap LECs in the provision of local exchange and exchange access services. By permitting incumbent, price cap LECs to recover from IXCs through interstate switched access charges their costs of marketing retail services, these potential competitors are forced to bear the incumbent, price cap LECs' costs of competing with the IXCs. Assigning recovery of marketing costs to end users, on the other hand, subjects these costs to the competitive pressures of the market.

323. Marketing expenses are currently recovered through all interstate access rate elements and the interexchange category in proportion to the investment originally assigned to these elements and categories by the Part 69 cost allocation rules.[455] Special access and interexchange services are purchased by, and marketed to, retail customers. It is therefore appropriate to allow rates for those services to continue to include recovery of marketing expenses.[456] Marketing expenses must be removed from all other rate elements by means of downward exogenous adjustments to the PCIs for the common line, traffic sensitive, and trunking baskets. With respect to the trunking basket, the exogenous adjustment shall not reflect the amount of any Account 6610 marketing expenses allocated to special access services. The service band indices (SBIs) within the trunking basket shall be decreased based on the amount of Account 6610 marketing expenses allocated to switched services included in each service category to reflect the exogenous adjustment to the PCI for the trunking basket.

324. After performing the appropriate downward exogenous adjustments described above to the PCIs in the common line, traffic sensitive, and trunking baskets, price cap LECs may recover the revenues related to the Account 6610 marketing expenses removed from these baskets by increasing the SLCs for multi-line business and non-primary residential lines. To prevent end-user charges from exceeding levels we have established earlier in this Order,[457] the amount of marketing expenses to be recovered from multi-line business and non-primary residential lines in their SLCs shall be limited by the ceilings we establish for these SLCs in this Order.[458] To the extent these ceilings prevent full recovery of these amounts, price cap LECs may recover these costs by increasing equally both the non-primary residential

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[455] 47 C.F.R. § 69.403.

[456] For example, in the *SNFA Order*, we found that certain marketing expenses incurred to provide customer contact operations, service order processing, and the billing and administration of special access services are properly included in special access rates. Investigation of Special Access Tariffs of Local Exchange Carriers, CC Docket No. 85-166, Phase I; Phase II, Part 1; and Phase III, Part 1, FCC 97-42 (rel. Feb. 14, 1997) (*SNFA Order*).

[457] *See* Section III.A.2, *supra*.

[458] In future years, these ceilings shall rise as set forth in Section III.A.2, *supra*.

line PICC and the multi-line business PICC, not to exceed the ceilings on the PICC for non-primary residential and multi-line business lines.[459] In the event the PICC ceilings prevent full recovery of these expenses, any residual may be recovered through per-minute charges on originating access service, subject to its ceiling. Finally, to the extent price cap LECs cannot recover their remaining marketing expenses through per-minute charges on originating access, any residual may be recovered through per-minute charges on terminating access service.[460] Although these marketing expenses will be recovered through the SLC, they shall not be included in the base factor or considered common line revenues. To prevent price cap LECs from recovering these expenses from access services, we are establishing a separate basket for these marketing expenses.

325. We reject, however, AT&T's assertion that recovery of interstate-allocated marketing expenses through interstate access charges violates the wholesale pricing provisions contained in section 252(d)(3) of the Act.[461] Section 252(d)(3) establishes a pricing standard for the wholesale provision of retail offerings to other carriers that resell the LEC retail services.[462] Section 252(d)(3) does not apply to the pricing of interstate access, which is not a retail service.

2. General Support Facilities

a. Background

326. In the NPRM, we sought comment on other possible cost misallocations that may contribute to the difference between embedded costs and forward-looking costs allocated to the interstate jurisdiction.[463] AT&T suggests that the allocation of embedded general support facilities (GSF) costs, including general purpose computer expenses, among access categories is one such misallocation.[464] This allocation, AT&T contends, results in the

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[459] *See* Section III.A.3, *supra.*

[460] *See* Section VI.C, *infra,* for a discussion of terminating access.

[461] AT&T Comments at 66-67. AT&T identifies and quantifies inappropriate retail expenses embedded in current interstate switched access rates based on the requirements of section 252(d)(3) and the criteria for wholesale rate cost studies outlined in the *Local Competition Order. See Local Competition Order,* 11 FCC Rcd at 15958.

[462] 47 U.S.C. § 252(d)(3). Section 252(d)(3) provides that wholesale rates will be determined on the basis of retail rates, excluding the portion attributable to marketing, billing, collection, and other costs that will be avoided by the LEC.

[463] NPRM at ¶ 254.

[464] For a more detailed background on GSF misallocation issues, *see* Section VII.B, *infra.*

inappropriate support of LECs' billing and collection service, which is a nonregulated, interstate service, through regulated access charges.[465] AT&T estimates that $124 million of expenses recovered in interstate access support the nonregulated billing and collection category.[466] Of the $124 million, $60.1 million is included in interstate switched carrier access, and $20.5 million is in interstate special access, with the remainder recovered by the SLC.[467]

327. The GSF investment category in Part 36 includes assets that support other operations, such as land, buildings, vehicles, as well as general purpose computer investment accounted for in USOA Account 2124.[468] Some incumbent LECs use general purpose computers to provide nonregulated billing and collection services to IXCs. Part 69 allocates GSF investment among the billing and collection category, interexchange category, and the access elements based on the amount of Central Office Equipment (COE), Cable and Wire Facilities (CWF), and Information Origination/Termination Equipment (IO/T) investment allocated to each Part 69 category.[469] Because no COE, CWF, or IO/T investment is allocated to the billing and collection category, no investment in general support facilities, and thus no portion of general purpose computer investment, is allocated to the billing and collection category. Likewise, because expenses related to GSF investment are allocated in the same manner as GSF investment, no GSF expenses, including expenses related to general purpose computers, are allocated to the billing and collection category. To the extent that costs are underallocated to the billing and collection category, incumbent LECs' regulated services recover through interstate access charges costs associated with nonregulated provision of billing and collection services.

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[465] In 1986, the Commission found that the market for billing and collection service was sufficiently competitive that it was not necessary to require LECs to provide that service as a tariffed common carrier service. The Commission did not, however, preempt state regulation of billing and collection services. *See* Detariffing of Billing and Collection Services, CC Docket No. 85-88, 102 FCC 2d 1150 (1986) (*Billing and Collection Detariffing Order*) *recon. denied*, 1 FCC Rcd 445 (1986). The Commission later decided to treat billing and collection costs as regulated for accounting purposes because such treatment was less likely to misallocate these costs between the interstate and intrastate jurisdictions. Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, Report and Order, CC Docket No. 86-111, 2 FCC Rcd 1298, 1309 (1987) (*Joint Cost Order*).

[466] AT&T Comments at 67-68, Appendix E at 2.

[467] AT&T Comments Appendix E at 2.

[468] 47 C.F.R. § 36.111.

[469] 47 C.F.R. § 69.307(c).

b. Discussion

328. We agree with AT&T and WorldCom that the current allocation of GSF costs enables incumbent LECs to recover through regulated interstate access charges costs caused by the LECs' nonregulated billing and collection functions. By shifting some costs from interstate access services to the nonregulated billing and collection category, we would move interstate access rates closer to cost. The NPRM, however, may not have provided sufficient notice to interested parties that we would change in the allocation of LEC interstate costs between regulated interstate services and nonregulated billing and collection activities. We therefore seek comment on this issue in Section VII.B below.

V. ACCESS REFORM FOR INCUMBENT RATE-OF-RETURN LOCAL EXCHANGE CARRIERS

A. Background

329. In the NPRM we concluded that, with limited exceptions, the scope of this proceeding should be limited to incumbent price cap LECs because these carriers face the potential of significant competition in the interstate exchange access market due to the new duties and obligations imposed upon them by the 1996 Act.[470] We proposed limited exceptions that would subject all incumbent LECs to the rules addressing allocation of universal service support to the interstate revenue requirement, discussed in Section VI.D, below, and to the reforms to the transport rate structure, including the TIC, discussed in sections III.D., above. We invited comment on these tentative conclusions on the scope of this proceeding. We also sought comment on whether we should apply our proposed changes to the common line rate structure to rate-of-return incumbent LECs and whether we should update Part 69 access rules in light of various developments. We further invited comment on the effect of these proposals and tentative conclusions on small business entities, including small incumbent LECs and new entrants.[471] We also noted that we would address access reform for rate-of-return carriers in a separate proceeding in 1997.[472]

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[470] NPRM at ¶¶ 50-52.

[471] NPRM at ¶ 53.

[472] NPRM at ¶ 52.

B. Discussion

330. We conclude that, with the limited exceptions discussed in Sections III.D and VI.D, the scope of this proceeding should be limited to price cap incumbent LECs.[473] Price cap regulation governs almost 91 percent of interstate access charge revenues[474] and more than 92 percent of total incumbent LEC access lines.[475] Currently, all ten of the incumbent LECs with more than two million access lines and 13 of the 17 non-NECA incumbent LECS with more than 50,000 access lines are subject to price cap regulation.[476] Therefore, even though this proceeding applies only to price cap incumbent LECs, it will nonetheless affect the vast majority of all access lines and interstate access revenues.

331. Small and rural LECs will most likely not experience competition as fast as incumbent price cap LECs. We do not expect small and rural LECs generally to face significant competition in the immediate future because, for the most part, the high cost/ low-margin areas served by these LECs are unlikely to be the immediate targets of new entrants or competitors. Moreover, as we noted in the NPRM, all non-price cap incumbent LECs may be exempt from, or eligible for a modification or suspension of, the interconnection and unbundling requirements of the 1996 Act.[477] By contrast, all incumbent LECs that are ineligible for section 251(f) exemption, suspensions, or modifications are incumbent price cap LECs.[478] Because the latter incumbent LECs must fulfill the section 251(b) and (c) duties to provide interconnection and unbundled elements to new entrants, they are likely to face significant competition in the interstate exchange access market before the small and mid-sized rate-of-return incumbent LECs face such competition.

[473] These incumbent LECs are the seven Regional Bell Operating Companies (Ameritech, Bell Atlantic, BellSouth, NYNEX, Pacific Bell, SBC, US West), Citizens, Frontier, GTE, Aliant (formerly Lincoln), SNET, and United/Central.

[474] Universal Service Fund Data Collection, CC Docket No. 80-286, Universal Service Fund 1996 Submission of 1995 Study Results by NECA, Oct. 1, 1996.

[475] Data based on LECs' 1995 and 1996 Annual Access Tariffs filed with the Commission.

[476] Data based on LECs' 1995 and 1996 Annual Access Tariffs filed with the Commission.

[477] For example, section 251(f)(1) exempts rural telephone companies from the requirements of section 251(c)(2) until the rural telephone company has received a bona fide request for interconnection, services, or network elements, and the state commission determines that the exemption should be terminated. In addition, section 251(f)(2) permits LECs with fewer than two percent of the nation's subscriber lines to petition a state commission for a suspension or modification of any requirements of sections 251(b) and (c).

[478] *See, e.g.*, USTA Holding Company Report 1996.

332. We recognize that small and rural rate-of-return LECs face unique circumstances and that a few of these carriers may now have, or may soon receive, bona fide requests for interconnection. Although all rate-of-return carriers may not be completely insulated from competitive pressures, we are not persuaded by arguments that delaying the initiation of an access reform proceeding for these carriers until later this year will have a detrimental impact on their viability. A separate proceeding for small and rural rate-of-return LECs will provide us with the opportunity to conduct a comprehensive review of the circumstances and issues unique to these carriers.

333. We do not agree that Citizens Utilities should be exempt from some of the rules we adopt in this order for price cap companies. The decisions we reach here accommodate many of the concerns that Citizens Utilities, as well as a number of other price cap LECs that serve rural areas, voices in its pleadings. Although Citizens Utilities arguably may face different circumstances than other price cap LECs that serve larger urban and suburban populations, Citizens has indicated, by electing price cap regulation, that it believes it can achieve a higher rate of productivity than smaller rate-of-return LECs and that price cap regulation is more beneficial to it than rate-of-return regulation. Citizens Utilities has not demonstrated that the modifications we are adopting in this proceeding would necessarily affect it differently than other price cap LECs. If Citizens Utilities believes that it cannot remain financially viable as a price cap carrier under the revised access charge regime, it may petition for a waiver of the rule that makes its decision to elect price cap regulation irreversible.[479]

334. We reject Centennial's suggestion that we adopt access reform modifications for *all* incumbent LECs but then grant waivers for small, rural LECs whose special circumstances warrant different accommodations. For the most part, rate-of-return LECs face a common set of complex issues, different than those faced by price cap LECs, that are better addressed in a separate proceeding. In that proceeding, we will address any differences that may exist between large and small rate-of-return carriers.

335. We therefore limit application of the rules we adopt in this proceeding to the incumbent price cap LECs, with limited exceptions. Because rate-of-return LECs will collect revenues from the new universal service support mechanisms, we address allocation of universal service support to the interstate revenue requirement for all incumbent LECs in Section VI.D. In addition, because rate-of-return incumbent LECs' transport rates were subject to the rules that were remanded by the court in *CompTel v. FCC*,[480] the changes to the

[479] In the *LEC Price Cap Order*, the Commission stated that a LEC's decision to elect price cap regulation is irrevocable. Policy and Rules concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786, 6819 (1990).

[480] *CompTel v. FCC*, 87 F.3d 522.

TIC that we adopt in Section III.D. pursuant to the court's remand, except for changes that require reallocation of costs to newly-created rate elements, will also apply to rate-of-return incumbent LECs. Finally, in order to prevent double recovery of the costs associated with providing access services to new entrants through the sale of unbundled network elements, we conclude in Section VI.A, below, that our exclusion of unbundled network elements from Part 69 access charges applies to all incumbent LECs.

VI. OTHER ISSUES

A. Applicability of Part 69 to Unbundled Elements

1. Background

336. In the NPRM, we requested comment regarding the potential application of Part 69 access charges to unbundled network elements purchased by carriers to provide local exchange services or exchange access services.[481] We tentatively concluded that unbundled network elements should be excluded from such access charges. We noted that the 1996 Act allows telecommunications carriers to purchase access to unbundled network elements and to use those elements to provide all telecommunications services, including originating and terminating access of interstate calls.[482] We further noted that the 1996 Act requires purchasing carriers to pay cost-based rates to incumbent LECs to compensate them for use of the unbundled network elements.[483] Accordingly, we tentatively concluded that the requesting carrier paying cost-based rates to the incumbent LEC would have already compensated the incumbent LEC for the ability to deploy unbundled network elements to provide originating and terminating access.[484]

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[481] NPRM at ¶ 54.

[482] *Id.*

[483] *Id.*

[484] *Id.*